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No. 92-1586

IN THE

Supreme Court of the United States

OCTOBER TERM, 1992

DEAN WITTER REYNOLDS INC.,
a corporation,

Petitioner,

v.

HUDSON T. HARRISON and HARRISON CONSTRUCTION INCORPORATED, a corporation,

Respondents.

Petition for Writ of Certiorari to the United States Court of Appeals for the Seventh Circuit

PETITIONER'S REPLY BRIEF

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REASONS FOR GRANTING THE WRIT

I. INTRODUCTION

As demonstrated in Dean Witter's[1] Petition, the law of Section 20(a) is in a terribly confused and contradictory state. Respondent Harrison relies on this confusion to obscure this Petition's principal issue, which is—whether an employer may be vicariously liable under Section 20(a) when it *is not* liable under common law agency, respondeat superior *or* negligence principles. Thus, by blatantly mischaracterizing the relevant authority, Harrison attempts to recast the consensus in favor of the converse proposition (i.e., that common law vicarious liability principles supplement Section 20(a) in securities law cases) as support for the holding in this case.

Here, the Seventh Circuit held that a broker-dealer bears the burden of proving a negative (non-negligence in any aspect of its supervision) if it is to escape *vicarious* liability under Section 20(a) for violations of Section 10(b) committed by an employee in personal transactions with *non-customers* that, as a matter of law, fell well (and transparently) *outside* the scope of *the employee's actual, implied, ostensible, and apparent authority.* This decision completely ignores all recognized principles of vicarious liability in favor of creating what amounts to an incredibly broad, negligence cause of action against broker-dealers for failing to supervise non-violative activity in employee accounts so as to insure the protection of unknown *non-customers* in their unknown and obviously unauthorized personal dealings with employees. By premising a broker-dealer's potential vicarious liability under Section 20(a) on

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[1] Petitioner Dean Witter Reynolds Inc. is a subsidiary of Sears Roebuck & Company.

its supervision of activity that neither violated the securities laws nor proximately caused plaintiff's injuries, the Seventh Circuit abolished any requirement that there be some nexus between the broker-dealer's "control" and the conduct for which it is to be held accountable as a "controlling person". Contrary to Harrison's arguments, this construction of Section 20(a) cannot be reconciled with its language, its legislative history, the 1934 Act's overall scheme or the law of any other circuit.

II. CONTRARY TO THE LANGUAGE AND LEGISLATIVE HISTORY OF SECTION 20(a), THE SEVENTH CIRCUIT'S HOLDING MAKES BROKER-DEALERS INSURERS OF THEIR EMPLOYEES' CONDUCT

Harrison argues that holding a broker-dealer vicariously liable for employee acts of which it was unaware, in which it did not participate, *and* that it neither actually nor apparently authorized is consistent with the legislative history of Section 20(a) and the statutory scheme of which it is part. To support this argument, Harrison cites only the "savings clause" and the "remedial purpose" of the Securities Exchange Act of 1934.[2] Harrison's reliance on the Act's savings clause and remedial purpose is completely misplaced.

The savings clause may be relevant in deciding whether agency principles supplement Section 20(a) as a basis for vicarious liability under the Act. The savings clause, however, sheds absolutely no light on the issue presented here—whether a broker-dealer's Section 20(a) "control" extends to conduct that it neither actually nor apparently authorized.

Second, as stated by this Court, "[t]he invocation of the 'remedial purposes' of the 1934 Act . . . will not justify

[2] Respondents' Brief in Opposition ("R.B.") at 12-13.

reading a provision 'more broadly than its language and the statutory scheme reasonably permit.' "[3] Thus, the Act's remedial purpose also does not evidence any intent by Congress to expand an employer's (even a broker-dealer's) liability for employee acts beyond the strict liability provided for by common law.[4]

Finally, while Harrison notes that all courts agree concerning the legislative history of Section 20(a), he completely ignores the most compelling aspect of that history—Congress' *collective* rejection of an insurer's standard of liability in favor of a fiduciary "good faith" standard.[5] Congress' express rejection of the insurer's standard proposed by the Senate strongly evidences an intent to limit liability under Section 20(a) to situations involving culpable conduct. Indeed, this Court has expressly recognized that Section 20(a) incorporates a state-of-mind condition that requires a showing of *something more than negligence* to establish liability.[6]

By requiring broker-dealers to prove non-negligence to escape Section 20(a) liability, the Seventh Circuit's holding not only makes broker-dealers the insurer's of their employees' conduct (*personal* as well as job-related) but also relieves plaintiffs of the burden of establishing *even* negligence (much less something more). Such a result is entirely inconsistent with the language and legislative history of Section 20(a)—a statute that was intended to extend

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[3] *Touche Ross & Co. v. Redington*, 442 U.S. 560, 578 (1979) (cite omitted).

[4] *See Hollinger v. Titan Capitol Corp.*, 914 F.2d 1564, 1579-83 (9th Cir. 1990) (Hall, J. dissenting), *cert. denied*, 111 S.Ct. 1621 (1991).

[5] *See, e.g., Paul F. Newton & Co. v. Texas Commerce Bank*, 630 F.2d 1111, 1116 (5th Cir. 1980).

[6] *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, nn. 27-28 (1976).

accountability to those who "control" violative conduct through power relationships other than employer/employee or principal/agent, not to expand an employer/principal's already strict liability for employee/agent conduct.[7]

III. THE SEVENTH CIRCUIT'S HOLDING IS DIRECTLY AT ODDS WITH THE LAW OF OTHER CIRCUITS AND IN ACCORD WITH THE LAW OF NO OTHER

The Petition demonstrates that no other court has ever extended a control person's liability under Section 20(a) to conduct for which an employer or principal could not be held liable at common law. Harrison's contrary argument, that the Seventh Circuit's holding is not in conflict with the law of other circuits, rests entirely upon gross mischaracterizations of the relevant authority.

For example, citing *Sharp v. Coopers & Lybrand*[8] and *Eisenberg v. Gagnon*,[9] Harrison asserts that the Third Circuit has "twice upheld vicarious liability *under the Act* without 'culpable participation'."[10] This assertion is entirely false. *Eisenberg* involved neither a Section 20(a) claim nor any issue concerning respondeat superior's role under the securities laws,[11] but simply affirmed a finding of respondeat superior liability under state law.[12] Similarly, *Sharp* did not reject, *but expressly reaffirmed*, a "culpable participation" standard for Section 20(a) liabil-

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[7] *E.g., In re Atlantic Financial Management, Inc.*, 784 F.2d 29, 33 (1st Cir. 1986), *cert. denied*, 481 U.S. 1072 (1987).

[8] 649 F.2d 175 (3d Cir. 1981), *cert. denied*, 455 U.S. 938 (1982).

[9] 766 F.2d 770 (3d Cir. 1985) (cited by Harrison as *Eisenberg v. Gelrod, Fox & Co.*).

[10] R.B. at 8-9 (emphasis supplied).

[11] 766 F.2d at 783 n.7.

[12] *Id.* at 783-784.

ity.[13] Although, the *Sharp* court went on to find that the error in failing to instruct the jury accordingly was harmless by holding that the Third Circuit's general rule that Section 20(a) preempts respondeat superior liability was not applicable where the accounting firm defendant had authorized that the tax opinion involved be issued in the firm's name.[14]

Harrison also misrepresents the law of the Second Circuit. Contrary to Harrison's assertion, *Marbury Management, Inc. v. Kohn*[15] does not even discuss a "control" standard, much less apply one that is either "functionally equivalent" to the one applied here or inconsistent with the "culpable participation" standard adopted by the Second Circuit in *Lanza v. Drexel & Co.*[16] As in *Sharp*, the principal issue decided in *Marbury* was that respondeat superior can provide an alternative basis for vicarious liability under the securities laws.[17]

Harrison also argues that *Hunt v. Miller*[18] demonstrates that the decision in this case is consistent with the law of the Fourth Circuit. Like *Marbury*, however, *Hunt* simply discusses what must be shown under Section 20(a) once "control" is established, not what must be shown to establish control.[19] More importantly, *Hunt* treats a lack of diligent supervision as evidence of the "culpable participation" that a plaintiff must prove to establish Section 20(a)

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[13] 649 F.2d at 185.

[14] *Id.* at 185-87.

[15] 629 F.2d 705 (2d Cir.), *cert. denied*, 449 U.S. 1011 (1980).

[16] 479 F.2d 1277 (2d Cir. 1973) (en banc).

[17] 629 F.2d at 712-15.

[18] 908 F.2d 1210 (4th Cir. 1990).

[19] *Id.* at 1215.

liability under Fourth Circuit law.[20] Requiring proof of culpability (bad faith) as part of a plaintiff's *prima facie* case is, of course, directly at odds with the Seventh Circuit's decision that the broker-dealer defendant must prove its good faith—even with respect to employee conduct that, as a matter of law, was strictly personal.

Finally, Harrison relies on the Ninth Circuit's decision in *Hollinger v. Titan Capital Corp.*[21] But, as the Petition points out, *Hollinger* does not allow for Section 20(a) liability where (as here) the "representative was acting outside of the broker-dealer's statutory 'control' . . . [because plaintiffs] were not *reasonably relying* upon him as a registered representative of [the broker-dealer]. . . ."[22] Accordingly, in a decision issued the day after the Petition was filed, on strikingly similar (but less egregious) facts, a broker-dealer was held not liable under Section 20(a) because the non-customer who entered into transactions that were neither actually nor apparently authorized "was not reasonably relying on [the employee] as a registered representative of [the broker-dealer]."[23] Another result that is directly contrary to the decision in this case.

The extent to which Harrison is forced to mischaracterize the cases he cites demonstrates just how out-of-step the holding at issue is. In effect, the Seventh Circuit inter-

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[20] *Id.*; *see also Carpenter v. Harris Upham & Co., Inc.*, 594 F.2d 388, 395 (4th Cir.), *cert. denied*, 444 U.S. 868 (1979) (under Section 20(a), broker-dealer's "bad faith" is an element of plaintiff's *prima facie* case).

[21] 914 F.2d 1564 (9th Cir. 1990) (en banc), *cert. denied*, 111 S.Ct. 1621 (1991).

[22] *Id.* at 1575-76 n.26 (emphasis supplied).

[23] *Kohn v. Optik, Inc.*, [Current Developments] Fed. Sec. L. Rep. (CCH) ¶97,435 at 96,418-421 (March 30, 1993).

preted Section 20(a), a vicarious liability statute, as implying a direct cause of action against broker-dealers for negligent supervision—a cause of action in which the broker-dealer bears the burden of proving non-negligence and in which the plaintiff (to whom the broker-dealer owes no common law duty of care) need not even establish a nexus between the broker-dealer's "control" and the securities law violations at issue. Such a result is simply not in accord with the law of any other circuit, regardless of the particular variation of control standard applied.

IV. HARRISON'S FACTUAL ARGUMENTS ARE IRRELEVANT TO THE PRINCIPAL ISSUE INVOLVED—WHETHER A BROKER-DEALER'S "CONTROL" UNDER SECTION 20(a) EXTENDS TO CONDUCT FOR WHICH EMPLOYERS CANNOT BE HELD RESPONSIBLE AT COMMON LAW—AND ALSO TO THE SECONDARY ISSUE, UNLESS NEGLIGENCE (AND NOTHING MORE) IS SUFFICIENT TO NEGATE SECTION 20(a)'S GOOD FAITH DEFENSE

In opposing the Petition, Harrison raises factual arguments concerning the adequacy of Dean Witter's supervision of certain activity in one of its employee's personal trading accounts—activity that neither constituted securities law violations nor proximately caused Harrison's injuries. In particular, Harrison argues that Dean Witter might have been more diligent in investigating the employee's source for the approximately $1.8 million[24] that

[24] It is not disputed that the primary source for these funds was the approximately $7.5 million the employees successfully persuaded Harrison and other non-customers to loan to them, *personally*, by misrepresenting that the funds would be used to buy municipal bonds in their personal accounts at steep discounts, available only to employees, that would allow the employees to "guarantee" exceptionally large returns to the non-customer lenders (5 to 10% in 30 to 180 days or 18 to 60% on an annualized basis).

he lost trading options in his own account. These factual arguments, however, are just as irrelevant to the Petition's first (and principal) question as they are to the common law issues of apparent authority and duty.

In affirming summary judgment on all but one of the multiple federal and state law claims asserted by Harrison, the Seventh Circuit held that, as matters of law:

1. Dean Witter had no common law duty to protect Harrison from the intentional torts of its employees because Harrison: a) was never a Dean Witter customer; and b) was not injured on Dean Witter's premises or through the use of Dean Witter property; and,
2. Harrison could have protected himself more easily than Dean Witter could have detected and prevented the fraud because any reasonable person would have understood that the employees' offer to share the benefit of their employee discounts was well outside the scope of their authority.[25]

The principal question presented by this Petition is whether, despite these rulings, Dean Witter still may be

[25] Harrison, of course, does not agree with the apparent authority ruling and has filed a Cross-Petition seeking its review. Indeed, Harrison's discontent with this ruling evidences itself throughout his brief in opposition, i.e., the disingenuous attempts to equate the consensus concerning respondeat superior's role in securities law cases to the holding at issue and the claim that the holding (styled "Dean Witter's claim") that any reasonable person would have understood that the transactions at issue were unauthorized "is contradicted everywhere in the record." R.B. at 14. Dean Witter will address the fallacies of Harrison's position in its Brief in Opposition to the Cross-Petition. The questions presented by this Petition, however, assume (as did the relevant holdings) that, as a matter of good law, Dean Witter neither actually nor apparently authorized its employees' personal loan transactions with Harrison.

held accountable to Harrison under Section 20(a) or, in other words, whether a broker-dealer may be deemed to "control" an employee's unknown personal transactions with strangers that the broker-dealer did absolutely nothing to facilitate or to (even implicitly) indicate were authorized. Only if this question is answered affirmatively—a result that would be inconsistent with the language, the legislative history, and all other judicial interpretations of Section 20(a)—does any issue arise concerning Dean Witter's supervision of its employees.

Second, it is undisputed that Dean Witter had and diligently enforced supervisory procedures that required its branch manager to review every piece of incoming and outgoing correspondence and to intercept all incoming checks. It is also undisputed that these procedures were purposefully evaded, to conceal the transactions, by having Harrison send his checks and wire transfers (all $4 million payable to the employee personally) to the employee's home or personal bank account. In light of these *undisputed facts*, any failure on Dean Witter's part to discover that money lost in the employee's personal account had been fraudulently obtained in private transactions with non-customers amounts to *no more than* negligence. Thus, the second question presented is whether a broker-dealer may be deemed to have acted in bad faith for simple negligence or whether something more is required. If something more than negligence is required under Section 20(a), as this Court has stated, then the Seventh Circuit's construction of that statute constitutes a serious

error and this Petition should be granted with respect to the second, as well as the first, question presented.

Respectfully submitted,

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